



February 22, 2011

By Electronic Delivery

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue NW
Washington, DC 20551

**Re: Docket No. R-1404 (Debit Card Interchange and Routing), RIN No. 7100 AD63
Notice of Proposed Rulemaking, 12 C.F.R. Part 235**

Dear Ms. Johnson:

Official Payments, Corp. (“Official Payments”) respectfully submits the following comments in response to the Notice of Proposed Rulemaking (“NPRM”) issued by the Board of Governors of the Federal Reserve System (the “Board”) pursuant to Section 920 of the Electronic Fund Transfer Act (“EFTA” or the “Act”).¹

Official Payments appreciates the diligent work of the Board as reflected in the NPRM. The Board made a number of important determinations and substantial progress toward establishing regulations regarding debit card interchange that will begin to remedy the market failure that has resulted in market power that has harmed merchants and service providers like Official Payments over the years. In particular, Official Payments lauds the Board’s proposed rule with respect to 12 C.F.R. § 235.3 regarding “reasonable and proportional” interchange fees. On its face, this rule has the potential to eliminate the long-standing interchange and wholly unjustified price discrimination against card-not-present merchants, at least with respect to covered debit transactions.

Official Payments processed over 18.7 million transactions worth more than \$7.7 billion last year. Card network transactions totaled 14.9 million and \$5.0 billion, virtually all of which were “card-not-present” transactions. Our fraud rate on these transactions was near zero: less than 2/100 of a percent for both credit and debit volume. Yet the payment networks continue to charge Official Payments excessively high interchange based on the fallacy that card-not-present transactions are inherently riskier than card-present transactions.

Not only do the card networks charge higher interchange on card-not-present transactions, network rules shift the ultimate risk of the transaction to the card-not-

¹ Official Payments is a wholly owned subsidiary of Tier Technologies, Inc., a leading provider of transaction processing, business process outsourcing, and related solutions.

merchant, which is the reverse of the card-present world. Thus, even when we execute a successful authorization and complete all verification steps in the required time windows, we bear, as a card-not-present merchant, the risk of the transaction without recourse. The networks attempt to justify interchange as a payment that is akin to insurance that guarantees payment. Yet with card-not-present merchants that rationale is a sham because this “insurance” almost never pays a claim, because card-not-present merchants assume the risk of fraud. And this system of double charging card-not-present merchants – first via interchange then via the chargeback system – is even more unfair when it is applied to low risk merchants such as Official Payments.

We cannot imagine a better example than Official Payments to illustrate the market failure that motivated Congress to pass Section 920. We write to urge the Board to reject the rationale which has for too long justified higher card-not-present interchange rates and to bring the Board’s attention to issues of concern to card-not-present merchants.

Reasonable interchange fees. “Reasonable” interchange fees should be the same for card-present and card-not-present merchants. Because the costs of authorization, clearance, and settlement (“ACS”) of these debit transactions are virtually the same, it necessarily follows that all merchants should pay the same basic rates of interchange.

Network exclusivity. Because networks and issuers actively suppressed PIN debit for years, Internet transactions currently depend upon signature debit. Only Alternative B (two networks for each type of transaction on a debit card) will provide any meaningful benefit to Internet merchants and service providers. In light of the history of the suppression of PIN debit, Alternative A – leaving millions of merchants with only one viable network option – would be a particularly unfair result.

Our detailed comments and specific proposals follow.

I. The Business of Official Payments

Headquartered in Reston, Virginia, Official Payments is a leading provider of electronic payment solutions in the direct biller market. Our clients include more than 4,300 direct billers across the country, including the IRS, 27 states, 350+ colleges and universities, 400+ courts, 3,600+ counties and municipalities, utilities, and other commercial clients. In one form or another – from telephone call centers and IVR (Interactive Voice Response) systems to the Internet – Official Payments has processed government payments for over 26 years. Official Payments is the only company to enable electronic payments for the IRS continuously since 1999, when such payments became possible. Today, Official Payments processes every IRS form that allows electronic payment – some 28 different IRS forms.

A. Official Payments Processes Millions of Card-Not-Present Transactions Each Year with Virtually No Fraud

Because of the nature of our business and our own diligent anti-fraud efforts, Official Payments experiences virtually no fraud. Few individuals are motivated to use stolen credit cards, for example, to pay property or income taxes, which carry their own severe penalties for non-payment.

In 2010, Official Payments processed over 18.7 million transactions worth more than \$7.7 billion. The payment network volume was 14.9 million transactions and \$5.0 billion dollars of volume. The vast majority of this volume – over 97% – was comprised of card-not-present transactions, split 47% to credit and 53% to debit cards. Our overall fraud rate on debit transactions is near zero: 0.0149%, or less than 2/100 of a percent.

Despite this total absence of fraud, like other card-not-present merchants and service providers, Official Payments pays card-not-present interchange rates that are more than double the rates of card-present merchants. And we also bear almost all risk of chargebacks on transactions made on our site.

**B. Public Sector Payments Require Visible Processing Fees
Which Are Paid by Consumers**

Unique to the public sector payments market is the fact that many government clients require payment of the full amount of tax payments – no deductions may be made for the payment of interchange or any other fees. In the case of the IRS, this is a requirement of the federal law which first directed the IRS to accept electronic payments. Many other government entities require the same treatment for the collection of any payments considered a “tax,” as well as other categories of fees.

As a result, in contrast to most payment card purchases where the consumer is unaware of interchange and related fees, Official Payments generally collects a “convenience fee” from consumers in addition to the amount owed.² This fee is typically a flat rate of 2.35% for federal transactions and can range from 2.25% to 3.00% based on payment type mix and volume for state and local taxes, education, and utility payments. Official Payments pays and passes along about 75% of the fee as interchange to issuers. Although interchange rates vary, Official Payments must impose the same convenience fee regardless of payment method, as current Visa and MasterCard rules prohibit steering customers toward cheaper forms of payment.

Today, the high rates of interchange imposed by the payment networks directly result in consumers paying more when making electronic payments to government entities. Last year Official Payments paid \$98 million in interchange, processing, and assessment fees to payment networks which was passed along to consumers in the form of convenience fees. Because convenience fees can chill consumers’ willingness to use our channel to pay their bills, lower interchange fees would lead to lower convenience fees to increase consumer acceptance of our electronic payment offerings. If interchange fees are substantially reduced, there is no doubt that our convenience fees – and thus the school, tax, and utility bills of thousands of consumers – will also decrease. The direct

² Approximately 85% of Official Payments’ transactions involve a convenience fee added to a payment.

billers market is extremely competitive and the cost of payment processing is highly transparent to our customers. Accordingly, consumers are certain to see a reduction in convenience fees.³

Most important, today the required convenience fee is a major impediment to greater utilization of electronic payments by consumers in this huge underserved market. The government payment market has long lagged behind the private sector. Growth in this sector is important, as these billers – from federal agencies to local tax authorities – process far too many check and cash payments, imposing extra cost, administrative, and security burdens on a variety of public agencies. More electronic payments will greatly reduce the amount of overall fraud in the system as well as reduce administrative costs.

C. The Visa Debit Tax Payment Program Vividly Demonstrates the Failed Payments Market

As other commentators have noted, the electronic payments market shows many signs of market failure. The Visa Debit Tax Payment Program, described below, is a vivid example of such failure.

In late 2008, Visa initiated the Debit Tax Payment Program, which caps convenience fees at \$3.95 for any payment classified as a “tax,” which could include license and user fees if called a “tax” by a local government. Under Visa rules, “the Convenience Fee for a Visa Debit Card Transaction must be a fixed or flat amount not exceeding US \$3.95 per Transaction, regardless of the tax payment amount.”⁴ Of this fee, \$2.50 (i.e., some two-thirds) flows to the issuer as interchange.⁵ Most egregious, however, is that Visa also charges an ad valorem network fee of 11 basis points on Official Payments, even though fees to Official Payments are capped at \$3.95.

Thus, with a \$1,000 payment, Official Payments collects \$3.95, of which \$2.50 goes to the issuer and \$1.10 goes to Visa as a branding fee – leaving \$0.35 net for Official Payments. But on a \$2,000 payment, Official Payments *loses* \$0.75.

The effect of the new fee structure imposed by Visa can be seen in our largest sector, Real Property Tax, accounting for 32% of our volume. Real property tax payments commonly range from \$2,000 for individuals and \$5,000 for businesses, and in many states range much higher. On a \$5,000 payment, Official Payments loses \$4.05 on interchange and Visa assessments. On a \$100,000 payment, our loss is \$108.55. Of

³ Flat interchange fees – rather than the current ad valorem fees – will also make this sector more predictable. Currently, Official Payments does not know with certainty the applicable interchange rate for a particular transaction until after settlement – and these fees can vary significantly, especially with rewards and commercial cards which comprise some 30% of our volume. Under the rules proposed by the Board calling for flat transaction fees across all debit card transactions, our business will be more clear and predictable, and overall costs to consumers will go down.

⁴ *Visa Operating Regulations – 15 October 2010* at 556, <http://usa.visa.com/download/merchants/visa-international-operating-regulations-main.pdf>.

⁵ *Visa U.S.A. Interchange Reimbursement Fees* at 2, <http://usa.visa.com/download/merchants/october-2010-visa-usa-interchange-rate-sheet.pdf>.

course, these losses are incurred before Official Payments covers its costs to handle processing, meet essential security and compliance mandates, and operate Internet sites, IVR systems and call centers so that consumers can access our services.⁶

With the Visa Debit Tax Payment Program, Visa has placed a flat cap on any debit convenience fee, while at the same time Visa earns a percentage fee. The program is but one example of the power of the payment networks to impose fees which are not only higher, but are also complex and unpredictable. However, Official Payments has little choice but to continue to accept Visa debit card transactions.⁷ Official Payments has long-standing, multi-year contracts that require acceptance of Visa Debit that were established before the Visa Debit for Tax program was announced. The public sector payment area is highly competitive, and accepting as many payment forms as possible is essential. Moreover, many consumers prefer to make government payments by debit card, and debit currently represents the majority of Official Payments' transactions.

II. Historically, the Payment Industry Has Used Arbitrary Merchant Categories to Justify Interchange That Does Not Reflect Actual Costs

A. Market Failure Has Allowed Payment Networks to Charge Card-Not-Present Merchants Double the Rate of Card-Present Competitors, While Shifting Liability at the Same Time

The market for merchant acceptance of payment card transactions (including debit card transactions) has not functioned competitively for well over a decade. In fact, the experience of Official Payments and other high quality Internet merchants and service providers is perhaps the most powerful evidence of a market that has failed. In this regard, since the Internet became a commonly used medium for commerce in the 1990s, the payment industry has required Internet merchants to pay vastly higher interchange rates than those paid by their direct competitors in traditional card-present environments, while at the same time shifting transaction liability to card-not-present merchants. These rates are some 98 basis points higher and more than double card-present rates.⁸

Payment networks initially claimed that card-not-present transactions posed higher risks to the system which justified extraordinarily high interchange rates. That justification has vanished over time as many sophisticated Internet merchants have emerged who achieve very low fraud rates, and overall Internet fraud rates have steadily

⁶ Currently, the weak economy is the only reason Official Payments is not losing more on payments to the IRS. When the economy recovers and individuals pay more income tax, the Visa Debit Tax Program may cause substantial losses in our IRS payments sector.

⁷ Indeed, recently both Visa and MasterCard increased program fees on 30 days notice, from 9.25 and 9.5 basis points, respectively, to 11 basis points. As discussed below in Section V, it is essential that the Board adopt strong anti-circumvention rules to curb the abuse of these or similar fees.

⁸ See Visa U.S.A. Interchange Reimbursement Fees – October 2010, <http://usa.visa.com/download/merchants/october-2010-visa-usa-interchange-rate-sheet.pdf> (comparing “CPS/e-Commerce Basic” rate with “CPS/Retail Debit—Performance Threshold I” rate).

declined over the last 11 years, as measured by CyberSource (now a subsidiary of Visa).⁹ In fact, the networks have made no adjustments to discriminatory rates applied to card-not-present merchants, even though since those rates were first implemented, new online merchant categories, such as those serviced by Official Payments, have come onstream with remarkably low fraud rates. To the contrary, the disparity in card-not-present debit interchange rates has *increased* over time despite higher volume (which continues to grow at double-digit rates) and the maturation of the Internet.¹⁰ As observed in the NPRM at 81725 n.19, today card-not-present transactions comprise fully 14% of signature debit transactions and 10% of debit transactions overall – percentages which will grow as mobile payments rapidly expand.

Internet merchants have been particularly harmed by the suppression of PIN debit by networks and issuers. In Canada, notably, the Interac PIN debit network is now facilitating Internet transactions without interchange. Yet after nearly a decade, PIN debit transactions – which clear faster, are less vulnerable to fraud, and incur lower interchange rates – are almost completely unavailable to Internet merchants and service providers in the U.S.¹¹ Products that could facilitate PIN debit purchases over the Internet have been available for the better part of a decade, but have not gained traction.¹²

As such, the treatment of card-not-present merchants vividly demonstrates the market failure of the current payments system that is marked by long-standing lack of competition and the persistent market power of the payment networks. Sophisticated Internet merchants and service providers like Official Payments pay double the rate of card-present merchants for the same transactions, while assuming nearly all liability for fraud. These higher rates for card-not-present merchants are purely the result of market power over such merchants, who have no viable alternative to accepting payments

⁹ CyberSource Online Fraud Report 2011 at 4, 5, 19.

¹⁰ Price discrimination is classic indicia of market power. See, e.g., *In re Brand Name Prescription Drugs Antitrust Litig.*, 186 F. 3d 781, 783 (7th Cir. 1999) (“price discrimination implies market power”); *United States v. Visa U.S.A. Inc.*, 163 F. Supp. 2d 322, 340 (S.D.N.Y. 2001) (“Defendants’ ability to price discriminate also illustrates their market power.”); *In re Visa Check/MasterMoney Antitrust Litig.*, 192 F.R.D. 68, 74 (E.D.N.Y. 2000) (“Another test of market power is the ability to engage in price discrimination”).

¹¹ Digital Transactions, *Web Merchants Set High Hurdles for Alternative Payments to Clear* (Apr. 13, 2005), <http://www.digitaltransactions.net/index.php/news/story/554>; Lauri Giesen, *Pinned Down*, Digital Transactions 34 (May 2008), <http://www.digitaltransactions.net/archivemag.cfm>, <http://www.digitaltransactions.net/files/0508cover.doc>.

¹² Issuers have historically pushed signature debit over PIN. See Barbara Pacheco & Richard Sullivan, *Interchange Fees in Credit and Debit Card Markets: What Role for Public Authorities?* Federal Reserve Bank of Kansas City, Economic Review 99 (1st Qtr. 2006), <http://www.kansascityfed.org/PUBLICAT/ECONREV/PDF/1q06pach.pdf>; Andrew Martin, *How Visa, Using Card Fees, Dominates a Market*, N.Y. Times (Jan. 5, 2010), http://www.nytimes.com/2010/01/05/your-money/credit-and-debit-cards/05visa.html?_r=1 (“Despite all this, signature debit cards dominate debit use in this country, accounting for 61 percent of all such transactions, even though PIN debit cards are less expensive and less vulnerable to fraud.”).

through Visa and MasterCard signature debit networks, despite their excessive rates of interchange.¹³

It is also worth noting that these higher interchange rates have been used to fund network deals with issuers. In other words, this industry has functioned with a form of perverse competition for issuers that has resulted in higher prices to merchants. This dynamic has injured Official Payments and we fully anticipate it to continue after the regulations go into effect.

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Through Section 920 of the EFTA, Congress intended to address the market's inability to provide effective competition for merchants by constraining the abuse of networks' (and issuers') market power over merchants.¹⁴ This intent is readily apparent from the text of the Act as well as its legislative history.¹⁵ In our view, any plausible interpretation of "reasonable and proportional" interchange must eliminate the discriminatory treatment of card-not-present merchants (at least with respect to debit transactions), a glaring example of this market failure.

III. Reasonable Interchange Fees Are Virtually the Same for All Merchants

Nothing in the EFTA suggests Congress intended to allow variation in interchange fees by merchant category. In fact, sanctioning continued price discrimination – which is a classic example of a dysfunctional and failed market – would be antithetical to the fundamental purposes of the Act. Rather, Congress intended that only actual issuer ACS costs for particular transactions comprise a reasonable interchange fee. *See* NPRM at 81734. As discussed below, variations based upon merchant category may result in fees which are not "reasonable and proportional" to an issuer's ACS costs and which could reinstate the networks' exercise of market power

¹³ As observed in the NPRM, Internet retailers currently have no alternative technology that could cut merchant costs. NPRM at 81723; 81741 & n.70, 81749. And so far, in Official Payments' experience, new solutions offering PIN debit technology over the Internet charge prevailing signature debit rates.

¹⁴ "It is of course elementary that market failure and the control of monopoly power are central rationales" for government regulation. *Farmers Union Cent. Exch., Inc. v. F.E.R.C.*, 734 F.2d 1486, 1508 (D.C. Cir. 1984) (citing Stephen G. Breyer, *Regulation and Its Reform* 15-16 (1982)); Cary Coglianese, Richard Zeckhauser, Edward Parson, *Seeking Truth for Power: Informational Strategy and Regulatory Policymaking*, 89 Minn. L. Rev. 277, 281-82 (2004) (citing "lack of competition" as one of the three primary types of market failure calling for government regulation).

¹⁵ The Board correctly observed that although the Act "requires only the consideration" of a number of factors, these enumerated considerations are clearly "indicative of Congressional intent." NPRM at 81734; *see* 156 Cong. Rec. 156, S3696 (May 13, 2010) (Remarks of Sen. Durbin) ("Right now in the United States, there are zero transaction fees deducted when you use a check. The Federal Reserve does not allow transaction fees to be charged for checks. But when it comes to debit cards, Visa and MasterCard charge high interchange fees just as they do for credit. Why? Because they can get away with it. There is no regulation, there is no law, there is no one holding them accountable."); Andrew Martin, *How Visa, Using Card Fees, Dominates a Market*, N.Y. Times (Jan. 5, 2010), http://www.nytimes.com/2010/01/05/your-money/credit-and-debit-cards/05visa.html?_r=1.

over disfavored merchants, contrary to the EFTA. Because ACS costs are virtually the same for all merchants, the Board’s final rulemaking should bar what the proposed Commentary calls “variation among interchange fees” unless such variation is tied to material differences in an issuer’s actual, allowable ACS costs.¹⁶

A. Variation Among Interchange Fees Should Be Prohibited Unless Tied to Issuer Costs

Variation among interchange fees by merchant category, particularly by card-present versus card-not-present distinctions, should not be allowed under any rule adopted by the Board. The NPRM discusses allowable costs, and the true ACS costs to issuers do not vary materially for card-not-present transactions. Indeed, the NPRM does not refer to any quantification of cost differences between the two types of transactions for issuers. However, Proposed Commentary 3(b)-4 (NPRM at 81759) and 3(b)-1 (NPRM at 81760) allows for “variation among interchange fees” – including for card-not-present transactions – so long as fees remain below the safe harbor or cap. NPRM at 81736. In our view, such variation should not be permitted.

For Internet merchants, discriminatory interchange is simply an exercise of market power by the networks, particularly Visa and MasterCard – not a strategy deployed to increase acceptance or justified by actual increased costs to process card-not-present transactions. Indeed, the disparity in rates has only increased despite the increased volume, maturity, and relative safety of the Internet channel with respect to merchants such as Official Payments. As the Board recognized, the Congressional intent behind the EFTA was to strictly limit these fees to the actual processing costs of issuers. NPRM at 81733-34.

Allowing variation of ACS costs for different types of merchants ignores the fact that properly defined, allowable ACS costs are virtually the same regardless of merchant category.¹⁷ As the Board is aware, the transaction messaging flow for debit transactions is identical for card-present and card-not-present transactions. NPRM at 81724. Without substantiation of purportedly higher and properly allowable ACS costs to issuers for particular card-not-present transactions, variation by type of merchant should not be permitted.

¹⁶ Although we make no specific proposal concerning the Board’s fraud adjustment rulemaking, we likewise suggest that any adjustment for fraud prevention costs should be sales channel-neutral and based upon actual merchant fraud experience, not upon discriminatory merchant categories.

¹⁷ For example, the identity of the transaction flow for card-present and card-not-present transactions can be seen in a 2003 publication of the Federal Reserve Bank of Kansas City, which presents several flowcharts setting forth “authorization,” “processing” and “settlement.” Terri Bradford et al., *Nonbanks in the Payments System*, 24-26 (Nov. 2003). In each chart, the messaging flows and processing steps for credit and signature debit (also known as “offline debit”) are the same for card-present and card-not-present transactions.

B. Rules Should Limit Allowable Costs to ACS (i.e., Non-Fraud) Costs

Official Payments supports the Board’s strict limitation of allowable costs to the issuer’s role in authorization, clearance, and settlement, in accord with the clear intent and plain text of the statute. *See* NPRM at 81734-35 (“This formulation includes only those costs that are specifically mentioned for consideration in the statute.”).

Under the Act, any adjustment to interchange based upon fraud prevention costs clearly belongs in a separate rulemaking under a different provision, EFTA § 920(a)(5). The Act’s plain text and statutory structure mandate separate consideration of issuer ACS costs and any “adjustments” for fraud prevention costs borne by all parties. This is confirmed by the Act’s legislative history. Senator Durbin, discussing the text of the Act on the Senate floor, stated that “It should be noted that any fraud prevention adjustment to the fee amount would occur after the base calculation of the reasonable and proportional interchange fee amount takes place, and fraud prevention costs would not be considered as part of the incremental issuer costs upon which the reasonable and proportional amount is based.”¹⁸

The Board properly rejected efforts by issuers and payment networks to distort these costs, such as by importing fraud prevention through an overly broad definition of authorization. *See* NPRM at 81760 (“An issuer generally performs separate activities with the primary purpose of fraud-prevention in connection with authorization. Those separate activities are not considered to be part of an issuer’s role in authorization under § 235.3(c)(1).”).

While the Board properly rejected efforts to import customer service costs into ACS, noting for example that *inquiries* about transactions are not part of clearance costs (NPRM at 81760), allowing the costs of “non-routine transactions” such as “chargeback messag[ing]” effectively imports fraud costs into the ACS calculation. *See* NPRM at 81739. Many chargebacks fall under fraud reason codes, and thus, including these costs imports fraud costs into the ACS calculation. Moreover, “initiating the chargeback message, and data processing and reconciliation expenses specific to receiving representments” are not part of the properly defined “clearance” function of an issuer. Most importantly, fraud-related non-routine transaction costs should be addressed as part of the separate fraud adjustment, and including those costs as part of the ACS calculation runs the risk of double counting to the detriment of merchants. For these reasons, we urge the Board to exclude chargeback and fraud processing costs from the ACS calculation.

¹⁸ 156 Cong. Rec. 105, S5925 (July 15, 2010) (“Further, any fraud prevention cost adjustment would be made on an issuer-specific basis, as each issuer must individually demonstrate that it complies with the standards established by the Board, and as the adjustment would be limited to what is reasonably necessary to make allowance for fraud prevention costs incurred by that particular issuer.”).

C. “Averaging” Across Issuer or Network Conflicts with the Act and Invites Continued Discrimination Against Internet Merchants

The Board requested comment on whether to permit issuers or networks to exceed the thresholds if “average” transaction costs fell within the safe harbor or cap. NPRM at 81738-39. We are strongly opposed to this approach because it is simply a veiled invitation for the networks to set card-not-present rates above the cap and permit fees which are not reasonable or proportional to the cost incurred with respect to card-not-present transactions, in clear violation of the Act.¹⁹

While the NPRM mentions the purported increased “flexibility” of this proposal, there is no discussion about what that means, let alone why flexibility in debit interchange rates is needed or consistent with the statute. The NPRM refers only to the ability to adjust pricing to “reflect differences in risk, among other things.” NPRM at 81738. Transaction risk concerns fraud, and as such should be addressed in the distinct rulemaking on any fraud adjustment – a rulemaking that, as the statute requires, must account for the cost of fraud to merchants, among others.²⁰ To the extent this reference to risk relates to card-not-present merchants, it is worth noting that such merchants currently bear nearly all the risk of fraud, and thus charging them higher rates under the guise of “flexibility” and fraud risks cannot be justified.

For these reasons, an averaging approach will result in the continued imposition of excessive and unjustified interchange fees on Internet merchants. Differential rates also perpetuate the current structure, where high-quality merchants whose business is limited to card-not-present transactions subsidize low-quality merchants across all merchant categories.²¹ As the Board recognizes, such an approach also conflicts with the text of the Act, which focuses on the costs to “the” particular issuer for “the” particular transaction – costs which do not vary by merchant type. NPRM at 81738.

¹⁹ Indeed, the averaging proposal likely originated in comment letters from Visa and certain unidentified banks during the first phase of the Board’s rulemaking. See Letter from Visa to Federal Reserve Board (Nov. 8, 2010), http://www.federalreserve.gov/newsevents/files/visa_comment_letter_20101108.pdf; Letter from Oliver Ireland, Morrison Foerster LLP to Federal Reserve Board (Nov. 5, 2010), http://www.federalreserve.gov/newsevents/files/morrison_and_foerster_comment_letter_20101105.pdf (substantially similar letter, using much of the same language, submitted on behalf of “a number of institutions” which are not identified). These letters proposed averaging so that “a network could set different rates based on merchant size, merchant segment, acceptance channel (e.g., card present vs. card not present),” without any suggestion that these transactions varied in actual cost to issuers. (Visa Comment Letter at 18.) The letters were also careful to note that “[t]he Board would need to periodically update the Average Effective Debit Interchange Rate as the underlying aggregate issuer cost profiles change over time” – thereby insuring that “average” costs would continue to rise with the growth of card-not-present transactions.

²⁰ The Act’s separate fraud adjustment provision dictates that the Board broadly consider “the nature, type, and occurrence of fraud” in debit transactions, EFTA § 920(a)(5)(B)(ii)(I), and account for the liability of all parties for fraud loss and fraud prevention costs, EFTA § 920(a)(5)(B)(ii)(IV & V).

²¹ It is important to note that low quality merchants that create risks for the system exist in both the card-present and card-not-present environments.

Moreover, we share the Board's concern that an averaging approach that requires an *ex ante* calculation of differential rates could result in the average exceeding the cap. This concern is aggravated by the possibility, if not the likelihood, that averaging based on *ex ante* calculations may understate actual card-not-present volumes (which are increasing and will continue to do so with mobile payments), thereby enabling the networks to continually overcharge merchants such as Official Payments. We see no easy corrective for this other than to require issuers to provide inherently unreliable growth forecasts for card-not-present transactions before each year and to rebate any such overcharges *ex post*. For these reasons, in addition to being unprincipled, this approach will present difficulties in administration that the Board should avoid.²²

IV. For Internet Merchants, Meaningful Limits on Network Exclusivity Must Turn on Authorization Method

In the NPRM, the Board requested comment on two alternative approaches to Section 235.7(a). Under Alternative A, issuers and payment card networks can comply if “the number of payment card networks on which an electronic debit transaction may be processed is not limited to less than two unaffiliated payment card networks.” NPRM at 81749. As the Board acknowledges, issuers and payment card networks can comply with Alternative A by placing one signature and one PIN debit network on debit cards, a result which is problematic for the reasons detailed below. By contrast, under Alternative B, issuers and payment card networks are prohibited “from directly or indirectly restricting the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks ‘for each method of authorization that may be used by the cardholder.’” NPRM at 81750 (citing proposed Section 235.7(a)(1), Alternative B).

In our view, only Alternative B is faithful to the letter of the statute as well as to its legislative intent. Section 920(b)(1) prohibits limiting the “number of payment card networks on which an electronic debit transaction may be processed” to only one network (or two or more networks that are affiliated). *See* EFTA § 920(b)(1)(A). The statute does not address how many networks a given card allows. Instead it requires that every *transaction* must have at least two routing options to create network competition for merchants.

For Internet merchants and service providers, to make this provision effective there must be at least two network options for each authentication method. Otherwise, the millions of transactions conducted over the Internet – *10% of all electronic debit transactions* – will be limited to only one debit network option in clear violation of the statute. Because there are many merchants who cannot readily accept PIN debit, the marketplace will not receive the benefit of competitive choice and price pressures for entire classes of transactions if Alternative A is adopted. NPRM at 81749 (discussing the

²² If the Board were to allow averaging across networks or issuers, higher interchange rates should not be imposed upon all card-not-present merchants. Rather, higher rates should be limited to demonstrably higher-risk merchants, whether card-not-present or card-present. Low-risk merchants such as Official Payments should not bear the costs of fraud of higher risk merchants, regardless of acceptance channel.

fact that, in addition to Internet merchants, T&E merchants cannot accept PIN debit, and only 2 of the 8 million merchant locations that accept debit currently accept PIN). A result that provides no routing options for millions of transactions cannot be reconciled with the statute. For these reasons, Alternative B is the only approach that is consistent with the letter and spirit of the statute.

Alternative B also is the only option that adheres to Congress's expressed rationale for enacting this provision. As Senator Durbin explained in reference to Section 920(b), "[t]his paragraph is intended to enable each and every electronic debit transaction – no matter whether that transaction is authorized by a signature, PIN or otherwise – to be run over at least two unaffiliated networks." 156 Cong. Rec. S 5926 (July 15, 2010). Given that some debit cards and some merchants are limited to one authentication technology, this mandate can be accomplished only with Alternative B. Put differently, this provision was enacted to create network competition for merchant acceptance, a dynamic that has long been absent in this industry, and one that hopefully will have a disciplinary effect on prices. That objective would be frustrated if millions of merchants are deprived of the ability to route debit transactions to lower-cost networks.

Additionally, Alternative B is likely to result in new entrants offering signature debit. The signature debit segment of the debit market has been dominated by Visa and MasterCard. In fact, with the exception of Discover's signature debit product, which was launched in 2006 and has achieved limited success to date, Visa and MasterCard collectively have had a complete monopoly on the signature debit portion of this market. That should come to an end under Alternative B. In that regard, it is worth noting that the PIN debit networks almost certainly will jump into this portion of the market if Alternative B is adopted, and that entry could conceivably stimulate vigorous competition in a sector that has seen little competition to date.²³ In fact, working with these networks would be a fast and easy way for issuers to enable multiple signature debit functionalities on their cards given that the PIN debit networks already process signature debit transactions as part of the services they provide their member banks. This provides a powerful additional policy reason to select Alternative B.

Finally, it is imperative that Alternative B be selected to ensure that all merchants have some ability to discipline network fees. This conclusion is reinforced by the inescapable fact that, even after the regulations go into effect, the market power that has plagued this industry will remain intact for the foreseeable future. Against that backdrop, the dominant networks will continue to have the ability and incentive to compete for issuers by raising fees to merchants as they have been doing for years. Because Section 920(b) reflects Congress's attempt to provide merchants with some competitive check against that power, that intent would be frustrated if the Board selected Alternative A and millions of merchants had no ready ability to react to increasing network fees via routing.

²³ Such entry has been blocked by exclusive deals that Visa and MasterCard have with virtually all of the banks to thwart competition in signature debit.

For these reasons, Alternative B is the only option that is consistent with the letter and purposes of Section 920(b)(1) and the only option which will provide any meaningful benefit to Internet merchants and service providers.

V. Official Payments' Experience with the Visa Debit Tax Payment Program Exemplifies Why Strong Anti-Circumvention Rules Are Needed

In the opening section of the Act, Congress granted the Board authority to adopt regulations “to prevent circumvention or evasion” of debit card restrictions. EFTA § 920(a)(1). More specifically, Section 920(a)(8) authorizes the Board to prescribe rules to ensure that network fees are not used “to directly or indirectly compensate an issuer with respect to an electronic debit transaction” and “to circumvent or evade” the regulation of interchange.

The NPRM at 81747 and the proposed Official Commentary to 12 C.F.R. § 235.6 (*see* NPRM at 81762) reflect the Board’s intent to adopt a broad proscription against circumvention as well as an express prohibition of one example of circumvention, net compensation. However, the Board should clarify its intent – and the fact that net compensation is not the exclusive test for circumvention – in the text of § 235.6 to avoid future dispute. This could be accomplished by adding language to § 235.6 that circumvention occurs – but is not limited to – when an issuer receives net compensation from a payment card network.

The experience of Official Payments with the Visa Debit Tax Payment Program is a clear example of the need for broad, flexible anti-circumvention provisions. Network fees have been increasing in recent years – both MasterCard and Visa raised these percentage fees to 11 basis points recently – reflecting the continuing market power of the dominant networks. This market power will not dissipate as an immediate or even foreseeable consequence of these regulations. In the perverse competition for issuers, network fees could easily substitute for interchange because, absent stringent anti-circumvention rules, networks can simply raise fees after the regulations go into effect and pass them along to issuers to replace lost revenue from interchange. The Visa Debit Tax Payment Program – where convenience fees and interchange is capped but Visa charges an unlimited ad valorem fee – is just one example of a program implemented unilaterally by Visa (there is no similar program at MasterCard) with perverse and punitive effects. Official Payments, however, currently has no choice but to accept Visa debit cards despite these conditions.

For these reasons, we believe that network fees should be capped until non-exclusivity under Alternative B with respect Section 235.7 is implemented. With non-exclusivity under Alternative B in place, we are optimistic that a less regulatory approach to network fees will be necessary because virtually all merchants will have routing options and the ability to discipline network fees by preferring lower cost networks.

We are also concerned that the NPRM does not indicate whether issuers are currently receiving net compensation with the deals they have in place. As such, we do not have visibility into the extent to which networks can increase network fees to

merchants to provide replacement revenue to issuers without contravening the net compensation standard for circumvention. And we are troubled that the NPRM explicitly permits networks to raise their network fees to merchants, including assessments such as those assessed by Visa in its tax program, even if those increases are designed to circumvent the regulations by offsetting interchange, provided that net compensation is not provided. NPRM at 81747.²⁴ Given the market failure discussed above, and the fact that it cannot be fixed overnight, if the Board declines to cap network fees prior to the implementation of Alternative B, we respectfully suggest that it should implement regulations that can be flexibly applied to network fee changes that circumvent the regulation of interchange, even if they do not run afoul of the net compensation standard.

* * * *

Thank you in advance for your attention to the comments in this letter. Please let me know if you have any questions. I can be reached at Alex.Hart@officialpayments.com or +1.571.382.1028.

Sincerely yours,

Alex P. Hart
President and CEO

²⁴ The Board's rationale for permitting increases to merchant fees and decreases to issuer fees is tautological. Even though the Board admits that such fee changes "could have the effect of offsetting reductions in interchange transactions," it defines away the obvious circumvention problem because such changes in network fee may not "necessarily indicate circumvention . . . absent net payments to the issuer." NPRM at 81747. Once one accepts that there can be circumvention without net payments to the issuer, the NPRM's reasoning collapses.